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Issues concerning SMEs' access to finance

Report by the UNCTAD secretariat

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INTRODUCTION

1. In almost all countries, including industrialized countries, financing is deemed as the major constraining factor for the development and expansion of small and medium-sized enterprises (SMEs). Consequently, Governments generally view financial support as the major component of promotion policies in favour of SMEs.

2. The promotion of SMEs in developing countries often finds justification in considerations related to poverty alleviation and employment-generation. Micro-enterprises are believed to increase employment of the poor in the informal sector and SMEs are, in general, labour-intensive. However, a policy in support of long-term dynamic development of the small-scale industrial sector should go beyond these considerations and be integrated into the overall industrial strategy of a country, if the basic objective is to help improve the efficiency of SMEs and make them healthy and viable. In the context of increasing openness and wider exposure of developing economies to international competition, the role that the small-scale industrial sector is expected to perform needs to be clearly understood and its promotion designed in line with the overall national policy environment.

3. Such questions as how financial mechanisms could be improved or what cost-efficient schemes could be implemented in order to encourage lending to SMEs could thus best be addressed once there is a clear picture of the role played by SMEs in an integrated development strategy. This role can differ from one country to another. Some countries (for example, Japan and the Republic of Korea) at the beginning of their industrialization process had based their strategy on the development of large industrial conglomerates.[1] However, the role of SMEs as sub-contractors or as producers of specialized products, or even as competitors with large enterprises was subsequently recognized and particular attention was donated to this aspect. Other countries, in contrast, started their industrialization process on the strength of SMEs (which could be regrouped in a cooperative structure). These subsequently expanded and became large industrial complexes (as was the case in Taiwan Province of China). It is important to note that the distribution of finance and credit is a determinant in the shaping of these industrial strategies. Between these two extremes, however, there are other successful models of industrial development that have relied on the constitution of both large enterprises and SMEs.

4. Large-scale production derives its efficiency from such factors as economies of scale and improved business and production organization through the possibilities of interlocking interest in various plants and firms. In these circumstances, what then explains the strength of SMEs? A number of factors may be cited:[2]

- Large industry has easier access to cheap capital while small industry has easier access to cheap labour; these respective advantages might keep the cost-scale in balance for both types;

- Sometimes manufacturers prefer to start a new line of products on a small scale to minimize risks;

- Small-scale production is advantageous where the material to work on is not uniform, where the processes are not amenable to quick replication and where the products are not standardized;

- Market imperfections, owing to consumer preferences or transport costs, limit the size of the market and the scope for large-scale production;

- Long-term structural changes in product markets, reinforced by innovations in information technology result in increasing

segmentation of markets, shifts towards flexible production systems which imply the scaling down of plants and which alter the relative importance of economies of scale, thus significantly strengthening the role of small-scale producers in the overall production system.'

- Large enterprises can rely on subcontracting networks with SMEs to increase overall efficiency in the whole production chain, especially as industrial competition now emphasizes non-price factors, product differentiation and creation of new products. Japanese large corporations have traditionally established such business relations with smaller enterprises supplying specialized components; other countries, such as Republic of Korea, have likewise favoured subcontracting relations on a large scale.

5. Alongside a "modern" small-scale industrial sector, in many developing countries micro-enterprises of the informal sector play an important role in short-term poverty alleviation and the containment of unemployment. It is often believed that this sector produces for the poor and needs much technological upgrading in order to be integrated into the formal industrial sector.

6. Although the role of SMEs in the development process is increasingly recognized, it is less clear why special measures should be taken to promote SMEs. In the case of micro-enterprises in the poor informal sector, the rationale for special support is obviously based on socio-economic and income redistribution considerations. It is less clear why small firms in the "modern" industrial sector deserve special promotion measures. Employment generation is not a sufficient argument: maintaining inefficient small firms to protect employment will create stagnation and retard development of the economy as a whole. The rationale for promotion of SMEs might perhaps also be based on arguments related to "infant-industry" protection and market imperfections and failures. The first argument would explain the protection and assistance of SMEs to help build up their competitiveness until they reach a self-sustaining growth level. The second argument lends support to special measures to correct market imperfections and failures (especially in capital markets), in order to reduce any bias against small-scale industry.

7. The heterogeneity of SMEs might complicate the design and implementation of support policies, in particular in the financing area. All types of SMEs might not respond in the same way to a set of financial support measures. It is, therefore, important to have in mind some kind of functional classification of SMEs which could be relevant for promotion policies. Furthermore, it should be noted that the small-scale industry is an easy-entry sector (barriers to entry are low, owing to low start-up capital requirements). It can therefore be prone to overcrowding (and excess capacity) a tendency that might be accentuated by support measures, thus, nullifying the impact of assistance.

8. This paper will address some of the problems related to SMEs' access to finance. The first chapter contains an analysis of activities of SMEs made with a view to broadly classifying SMEs for a better targeting of support programmes. A distinction has been made, for example, between small industry which is competing with, independent of, or ancillary to large industry. To such SMEs must be added micro-enterprises which are operating mostly in the informal sector. Each type of SME might have specific needs calling for different treatment.

9. The paper subsequently analyses the financial requirements and constraints of SMEs (Chapter II). The difficulties faced by SMEs in securing access to finance from formal financial institutions might be owing to factors related to government financial policies, to the level of development of domestic financial systems, or to specific characteristics of SMEs.

10. Chapter III discusses measures to support SMEs' access to finance. Finally, some broad conclusions are drawn in the light of the analysis.

I. A FUNCTIONAL CLASSIFICATION OF SMES

11. Given the heterogeneity of SMEs, a functional classification of these enterprises is a difficult exercise, because of the selection of criteria to use for such a classification.[4] A first classification based on the degree of technology used in the production process distinguishes between three subsectors:[5]

- *A survival subsector:* comprising the informal micro-enterprises engaged in marginal economic activities, whose returns are extremely low;

- *A micro-enterprise subsector*: made up of firms with up to ten workers, using traditional technology and serving local markets. These firms are also found in the informal sector of rural and urban areas, accounting for the major part of employment in retailing, services and transport.

- *A small-scale enterprise subsector*: consisting of larger firms having between 10 and 50 workers and using more modern technology.

12. This classification could serve the purpose of defining different methods of assistance required by different types of firms. Survival activities require broad, integrated programmes (including social infrastructure, training, technical assistance and credit) as well as concessional terms. Micro-enterprises would require essentially simple and easily accessible credit schemes, marketing and commercialization services, simple managerial training and, sometimes, basic technical assistance. Small-scale modern units, being better endowed with management and commercialization capacity, might be in a position to benefit simply from an improvement in supply institutions, such as viable financial institutions.[6]

13. Another classification can distinguish between two main subgroups: the first includes micro-enterprises mostly active in the informal sector; the second comprises SMEs operating in the "modern" industrial sector. Within the second subgroup, it is useful to classify activities in relation to large-scale industry, so to reflect a country's industrial organization.[7] Thus, distinction could be made between:

- Autonomous small industry which is independent of large industry - this sector includes handicrafts, suppliers of services or other specialized products. The particular needs of this sector are often related to access to resources and markets, as well as working capital. SMEs in this sector might need the extension of other services accompanying the provision of finance.

- Small industry whose production is in competition with large industry - the viability of this sector depends on such factors as competitive prices, product quality and durability, work precision and speed, reliability, etc. Access to cheap credit can help SMEs in this segment to remain competitive, as they employ relatively cheap labour.

- Small industry which is complementary to large industry on which it depends for its inputs and market. SMEs act as subcontractors for large firms and, as such, might benefit from technical assistance and the financial support of their clients. Some countries actively encourage such cooperation between large and small firms.[8]

14. Countries might choose other classifications which could reflect better their industrial policy (for example, according to sectoral activities, with priority sectors reserved for certain types of firms). Whatever the classification chosen, this should serve to implement promotion programmes with the objectives of favouring growth-oriented and viable units and those satisfying socio-economic criteria and encouraging dynamic backward and forward linkages between firms (for

example through clustering of units or subcontracting). The second point is perhaps of particular importance for improving access to finance, as linkages will help to reduce transactions costs and reinforce the financial position of SMEs.

II. FINANCING OF SMES

15. Surveys of SMEs in developing countries have highlighted the problem of financing as the major obstacle for their development and expansion. SMEs have generally limited access to sources of finance, especially finance from formal financial institutions. There are myriad reasons for this:[9]

- Lending to small enterprises is perceived as risky because of the uncertainties faced by these enterprises (high failure rate and high susceptibility to market changes and economic fluctuations);

- The administrative costs of lending to small enterprises are high, and the size of loans is too small to cover these costs. (The transaction costs must include the risk element and potential losses);

- There is an institutional bias toward lending to the larger corporate sector, because of links in directorships, joint ownerships and other joint financial dealings between banks and large enterprises;

- The administrative formalities, time and paper work involved in obtaining credits from banks often deter SMEs from approaching banks. Moreover, small enterprises are often unable, or unwilling, to present full accounting and other documentation called for by banks;

- Small borrowers are unable to provide the collateral and security demanded by lending institutions.

16. These difficulties are compounded in countries where the financial systems are weak and capital markets nonexistent. Moreover, problems are exacerbated when tapping sources of long-term finance, as commercial banks provide mostly short-term loans while specialized institutions which provide long-term finance are scarce. SMEs, consequently, have to rely primarily on the proprietors' own resources and retained earnings to finance their operations. Money-lenders and curb financial markets often provide bridging finance, but at a substantial cost. In these circumstances, what mechanisms and policies should be implemented to enhance SMEs' access to finance from financial institutions? In countries where the informal sector plays an important role, is it necessary to increase the linkages between the formal and informal sectors so as to improve the supply of finance to SMEs?

A. Capital structure and financing needs

17. The primary source of initial capital for SMEs is the proprietors' own savings and that of relatives or close friends; for expansion, reinvested earnings are the main source of funds. This finding seems to be generally applicable in most developing countries. A study of financing of SMEs in Latin America has shown that SMEs in this region exhibit low debt-equity ratios (equity is understood here as proprietors' own resources).[10] In Mexico, for example, this ratio amounted in 1993 to 0.27 for small manufacturing firms, against an average level of 0.66 in the manufacturing sector. It is also reported[11] that self-finance as a percentage of fixed capital amounted to 80 per cent in Mexico, 92 per cent in Brazil, 65 per cent in Bolivia, 84 per cent in Colombia. Self-finance also funded 87 per cent of the working capital of SMEs in Mexico, and 97 per cent in Brazil. The second major source of finance comes from relatives and friends.

18. In Africa, a similar pattern has been noted.[12] A survey in 1979 indicated that the percentage of proprietors' own savings in start-up capital was between 59 per cent to 98 per cent in Nigeria, 78 per cent in United Republic of Tanzania, 60 per cent in Sierra Leone, 77.5 per cent in

Uganda. The funding by relatives was equivalent to between 35 per cent and 1.9 per cent in Nigeria, 90.8 per cent in Ghana, 15 per cent in United Republic of Tanzania, 19.5 per cent in Sierra Leone. The third largest source of funding came from money-lenders who lent up to 22 per cent in Uganda and 18 per cent in Sierra Leone.

19. In Asia, a survey in 1990 on the role of SMEs in the industrial development of selected Asian countries[13] indicated that private sector non-institutional funds (including proprietors' own funds and relatives' loans) was used as start-up capital. However, as firms expanded, start-up capital became a relatively small part of total capital invested. Sources of capital for expansion were more varied. In the case of fixed capital, the reinvestment of earnings was generally the main source of funds (50 per cent or more in the case of Bangladesh). Next came institutional and non-institutional sources (including informal sector finance). The dependence on reinvestment of earnings increases as firm size decreases. The amount of external capital financing was small.

20. In the case of working capital, SMEs in these Asian countries did indeed rely on institutional finance (from private and public banks) for a significant part. In Indonesia, for example, it appeared that about 20 per cent of small firms' and 40 per cent of medium-sized firms' working capital needs were met by external sources (mostly banks).

21. The Asian survey found that the less developed the financial markets were, the higher was the dependence on one's own and informal sector finance. Moreover the less formally organized the SMEs were, the less access they had to formal finance.

22. In contrast to the financial structure noted in most other developing countries, SMEs in the Republic of Korea exhibited a quite different pattern[14] as banks were the most important source of finance with a share of well over 70 per cent in total external financing during the 1980s. After the liberalization of the financial markets in the early 1980s, banks increased further their SME financing activities. Thus, since the 1980s, SMEs have no longer been considered as risky clients, having acquired a good credit standing based on their strong growth. Lending to SMEs had represented, on average, half of total loan portfolio of commercial banks in 1989. Likewise, the share of lending to SMEs in the non-bank sector, including finance companies and securities markets, was also increasing. However, for SMEs, the cost of borrowing for SMEs was still higher than that of large enterprises, although the difference tended to narrow over time. Collateral has also been an important factor in SMES' access to finance, although the percentage of loans without collateral was increasing.

B. Formal financial sector

23. The structure of the financial system of a country plays an important role in its development, insofar as it determines access to sources of finance for different categories of borrowers, aiding or constraining certain types of capital formation according to the decisions (or preferences) of lenders. In turn, economic growth affects the development of the financial system, as growth will create new demands for more or new kinds of financing. The ability of the financial system to respond to these demands will also depend on the regulatory and political environment governing financial activities.

24. A well-developed financial system would have many different types of financial institutions and instruments which would match different risk/return and time preferences of investors, and different needs, cost-evaluation and risk-hedging behaviour of borrowers. It would be able to provide both short-term and long-term debt instruments, and risk capital (stocks and related instruments) to finance the development of enterprises. The less developed and diversified a financial system is, the more restricted will be the access of small and risky borrowers to sources of finance.

25. In a perfectly competitive financial market, every lender would have a perfect knowledge of the probability of repayment of borrowers and would take lending decisions on the basis of his or her information about the project to be financed (which would be the same as the information possessed by the borrower). In the real world, there is often a problem of asymmetric information between borrowers and lenders. Lenders possess less information about the project to be financed and may have to acquire this information at a cost. This results in credit rationing, as some borrowers are excluded from the credit market even though the expected returns on their projects may be good. Credit rationing because of lack of information generally affects small enterprise borrowers.

26. SMEs are perceived as risky borrowers, as they are more vulnerable to economic fluctuations. Given the small size of loans to SMEs, the transaction costs of lending, including the risk element and potential losses, are high. Costs of monitoring the performance of such loans are also proportionately high. For these reasons, lenders raise the rate of interest charged on SMEs and demand stringent collateral. In the absence of markets for risk capital, high costs of borrowing and collateral requirements will further restrict the financing of SMEs.

1. Commercial banks

27. The financial systems in developing countries are dominated by the commercial banks. Commercial banks mobilize savings through deposits from households and business enterprises. They make mostly short-term loans; in countries with high inflationary tendencies, this short-term characteristic of bank lending is accentuated.

28. The high risk as perceived by commercial banks makes them shy away from lending to SMEs. Despite higher interest rate on lending to small firms, banks often find that the spread between deposit rates and lending rates is not sufficient to compensate for the high risk and costs involved in gathering information and monitoring loans. Raising interest rates, it is feared, might increase the probability of default, since high rates might decrease the ability and willingness of a borrower to pay. In practice, banks cannot easily distinguish the degree of risk and would in any case seldom be free to increase interest rates to the degree required.

29. Collateral reduces the risk of non-repayment, but arranging collateral and foreclosing, if necessary, will always involve administrative costs.

30. In many developing countries, the lack of skilled staff forces banks to reduce the number of loans administered by bank staff. In order to achieve high profitability, banks concentrate their lending to the large industry sector. In certain countries, privileged access to bank loans by large enterprises results from the interlocking between major corporate and bank interests.

31. It has been found that banks invest primarily in sectors and activities which assure greatest safety and profitability of investment. In Africa[11], for example, the direction of lending is skewed to commerce and trade. Moreover, for lack of viable and safe investments, a percentage of national savings deposited in banks remain idle, especially in the case of foreign banks. This has a tendency to discourage efforts to mobilize further deposits. The aggregate financial position of the banking industry in Africa has been characterized by frequent bouts of financial distress. Weakened by low capitalization and large losses, many financial institutions have become less able to provide credit to new clients and reluctant to open their doors to small borrowers.

32. Imperfections in the process of financial intermediation through the banking system, thus, make financing not equally available to all borrowers and tend to restrict finance to the short-term end. These imperfections have been attributed to a lack of development of formal lending institutions, bankers' risk perception towards SMEs (resulting in high

interest rates and lack of access to credit for small borrowers), as well as the privileged relationship between large corporate and banking sectors. This suggests that measures to reduce such imperfections would involve institutional development, the reduction of risks of lending and an increase in competition between banks.

2. Development banks

33. Governments in developing countries have established development banks which are in most cases funded from government budgets and contributions from external bilateral and multilateral donors. Development banks provide long-term finance for investment in selected sectors and they play a useful role in promoting industrial development. The creation of these banks purports to combine developmental objectives with sound banking practices. Many such institutions have also special "windows" to provide long-term finance to SMEs, albeit on a limited basis.[9]

34. The Development Bank of the Philippines, the Industrial and Financial Corporation of Thailand, Bangladesh Shilpa Bank and the Development Finance Corporation of Sri Lanka are examples of Asian development banks that have developed separate SME lending units. In Africa, the Development Bank of Zambia, together with other Zambian institutions and in combination with contributions from the Governments of the Netherlands and of Germany, had established, in 1983 the Small-Scale Services for SMEs. The Development Finance Company of Kenya set up in 1984 the Small Enterprise Company, with the financial contribution from the Netherlands. The Botswana Development Finance Corporation and the National Development Bank, also with financial contributions from the Netherlands, set up in 1984 Tswelolo Limited in order to provide loans to SMEs. The Nigerian Bank of Commerce and Industry and the Crédit de Côte d'Ivoire also provide term finance to SMEs.

35. The Development Bank of Mauritius has implemented a successful SME lending programme, by operating a network of one-man regional offices able to respond quickly to SME needs and to monitor effectively the borrower's performance. The Industrial Development Bank of India helped to set up State Financial Corporations and acted as an apex institution to channel funds to these corporations, particularly for lending to SMEs.

36. Some development banks also provide refinancing facilities whereby loans extended by commercial banks to SMEs are rediscounted by a fund created for this purpose in apex institutions. Refinancing has the added advantage of helping commercial banks to build up their capacity to appraise SME loans.

37. Many of these banks had been facing serious financial problems, which in some cases threatened their very survival. Most of them were suffering from heavy arrears on loans made and were not able to realise a reasonable level of profitability, as their income was insufficient to cover operating costs or to provide for the inherent risks of development financing. Insignificant levels of profitability have deterred development banks from mobilizing commercial resources; they consequently remained dependent on international aid and government funding. Limited resources and attempts to raise profitability had, over time, pushed their activities towards large-scale business.

38. Apart from their financial problems and limited resources, other characteristics of development banks have constrained their dealings with SMEs. Usually very centralized, they lack the branch network that is needed to respond quickly to the demands of SMEs. They usually do not lend working capital, which is often the primary financial need of SMEs. The documentation and paperwork required to obtain a loan result in the slow processing of loan requests and represent an obstacle for SMEs to approach these banks. The setting up by development banks of independent subsidiary units to deal with SMEs might help to overcome some of the problems by obtaining special low-cost funds from the government and from foreign

donors, and by special staffing to monitor loans and to offer ancillary services (such as advisory services, training programmes, marketing services).

39. Although experiences of development banks in developing countries in providing term finance to SMEs have met with mixed results, in many countries there is no alternative for Governments and foreign donors than to use development banks as the major conduit for financing SMEs. Where the commercial banks are unwilling or unable to become involved in lending to SMEs, as in many African countries, development banks remain the major source of finance, apart from non-banks sources. Development banks are also more willing to finance new enterprises or riskier but viable projects than commercial banks which, because of their conservative practice, are reluctant to approve such loans. Development banks are also perhaps more willing to invest in staff trained to help small business to prepare their projects for loan requests.

3. Special SME financial institution

40. Many countries have established separate financial institutions to provide credits exclusively to SMEs. The Netherlands was the first country to create such an institution. In 1927,the Government of the Netherlands created the Netherlands Bank for Small and Medium Business, with the participation of 25 small banks and the Government as the major shareholder. However, over the years this institution lost its specific SME orientation and has turned to larger clients as well, the more so as all commercial banks began to lend more to SMEs.

41. In the Republic of Korea, two special financial institutions have been established for financing SMEs. In 1961, the Small and Medium Industries Bank (SMIB) was established, following the adoption of the Small and Medium Industries Act. SMIB was fully owned by the Government under the close supervision of the Ministry of Finance, it was required to provide both long- and short-term finance to SMEs. Although SMIB is a development institution benefiting from government support and designed to extend financial and technical assistance to SMEs, it operates as a commercial bank and is allowed to mobilize deposits and lend on a short-term basis. SMIB became a major instrument in the financing of SMEs in the Republic of Korea.

42. In 1963, the Government of the Republic of Korea created a second institution, the Citizens National Bank (CNB), a state-owned commercial development bank providing credit to the consumer, household and small business sector. In practice, there was considerable overlap between CNB and SMIB; in order to reduce this overlap, CNB was allowed to finance enterprises employing up to 100 persons, while SMIB dealt with enterprises of up to 300 employees. Competition between the two institutions has pushed SMIB to finance larger and larger enterprises. Interest rates on loans extended by CNB and SMIB have been strictly regulated by the Government.

43. In Colombia, the Corporacion Financiera Popular (CFP) was created in 1967, funded by the Colombia Central Bank and external donors (including the World Bank) and designed to provide credits exclusively to SMEs. It was found that CFP made a significant contribution in increasing the supply of long-term finance to SMEs.However, in an attempt to expand its activities and to provide technical assistance to SMEs, CFP incurred high administrative costs.

44. In Turkey, the Government established in 1938 the Halk Bank to provide short- and long-term credit to SMEs. Halk Bank has also benefited from financial contributions from the World Bank and other bilateral donors. Halk Bank has lent at highly subsidized rates, although applying stringent collateral requirements at the same time.

45. In Pakistan, the Industrial Development Bank of Pakistan (IDBP) was established in 1961 has provided credits to SMEs. However, the low

profitability and the poor performance of its loan portfolio had forced IDBP to enlarge its operations and to lend to large enterprises as well.

46. Overall, these specialized institutions have indeed played a role in increasing finance available to SMEs. However, problems have often occurred because of the low profitability which did not allow the high transaction costs (including losses) to be covered fully. Therefore, most of these institutions have either tended to diversify their operations and reach larger enterprises or to rely increasingly on low-cost funding from Governments or external donors.

4. Savings banks and credit cooperatives

47. Savings banks are usually established on the premise that linking savings with credit delivery for SMEs can encourage greater participation of borrowers in the management of loans and ensure adequate repayment levels, as borrowers are asked to deposit savings with the banks in order to qualify for loans (which can be a multiple of the original savings). Savings allow the banks to build up resources for lending, without constantly relying on external official funding. SME borrowers are encouraged to save to accumulate reserves for future growth and as protection against economic downturns. As borrowers also contribute to the funding of the banks, they have a direct interest in the financial solvency of their institutions.

48. In developed countries, such institutions as the German Saving Bank Association, the Japanese mutual loan and savings banks and credit cooperatives, the Crédit Mutuel of France and the Canadian savings and credit organizations have played a useful role in financing SMEs. In developing countries, savings banks and credit cooperatives have also been established, catering to the needs mostly of micro-enterprises. A few cases are reviewed below.

(i) *Grameen Bank of Bangladesh*

49. The Grameen Bank was started in 1976 to provide credit to the landless poor.[7] Until 1983, Grameen Bank acted as an intermediary to give poor borrowers access to credit extended by the state-owned banks. In 1983, with financial contributions from the International Fund for Agricultural Development (IFAD) and the Bangladesh Bank, it became an independent bank for the landless poor.

50. An important element of Grameen Bank's operations is the coupling of savings and credits. The Bank has established a rule that all borrowers must deposit weekly savings, basing credit eligibility partly on their ability to maintain the savings discipline. In addition, the borrower pays interest and deductions amounting to 24.5 per cent of the loan: 13 per cent as interest, 5 per cent in the form of savings in a group fund, and 6.5 per cent as contributions to an emergency fund. The savings operations of the Bank have become an important source of capital for its lending operations; savings in 1986 were equivalent to nearly half of outstanding loans. However, the Bank so far still relies on IFAD funds and other soft loans or grants from bilateral donors.

51. The average size of individual loans is very small and does not exceed US$ 230. It is to be noted that by 1991, 92 per cent of the borrowers were women.

52. Grameen Bank operations have expanded at a rapid pace, from 362 villages involved in the programme to nearly 23 000 in 1991. The Bank's organizational structure is based on groupings at the village level. At its base are groups of five selected villagers who carry out activities in that village. Ten or so of these village groups form larger groups called centres. Branch offices supervize several centres.

53. Despite considerable success in loan recovery and the wide coverage of its lending operations, Grameen Bank, although financially viable (owing

to subsidized external funding), had still not made any profit by the end of 1991. This may be due to the interest rate limits imposed by the Government, which did not allow it to cover the high transaction costs.

54. The high repayment level (about 98 per cent of loans) has been explained by the "peer pressure" of the group process. The village groups have demonstrated a commitment to mutual support and a significant capacity to appraise each others' projects.

(ii) BancoSol of Bolivia

55. BancoSol started operations in Bolivia in 1992, following the model of Grameen Bank." It grew out of the success of PRODEM (Fundacion para la Promocion y Desarrollo de la Microempresa), a nonprofit lending programme for microenterprises.

56. PRODEM received support from USAID and ACCION International (a non-profit NGO based in the United States) to launch a programme to support microenterprises in 1987. PRODEM followed the methodology that had been employed in other Latin American countries. Its clients were organized as solidarity groups whose members were collectively responsible for loan repayment and for guaranteeing the loans of group members. In addition, PRODEM captured savings from its borrowers, by adopting a mandatory savings of 5 per cent of each loan. These savings were placed in individual accounts which earned market interest rates. Clients had access to their savings once they paid off their loans and wished to leave the programme.

57. As its operations expanded, PRODEM found it necessary to obtain resources other than subsidized loans and donations from international donor agencies. As an NGO, PRODEM was legally restricted from seeking alternative sources of funding such as deposits, commercial debt, shareholder investment, and loans from the Central Bank of Bolivia.

58. The PRODEM lending programme has been replaced by BancoSol, which benefited from capital contribution from the International Finance Corporation and the Inter-American Development Bank, among other shareholders. BancoSol is a commercial bank, which attracts savings through time and demand deposits, in addition to the compulsory savings of its borrowers. No minimum amount is required to open an account. The interest rate paid on deposits was 20.4 per cent, as of June 1992, which was slightly lower than market rates. BancoSol also raises resources through borrowing from development organizations, other banks and through issues of bonds.

59. BancoSol makes loans at an interest rate of 55 per cent to 57 per cent per annum, as of June 1992. Other commercial banks' rates fluctuated between 28 per cent and 31 per cent. The average size of BancoSol' s loans is US$ 277, as compared to the average size of US$ 35 000 to US$ 120 000 for other commercial banks. Some 70 per cent of BancoSol's borrowers are women. The method of solidarity group lending is maintained. The default rate remains very low.

60. Despite high administrative costs associated with micro-lending, BancoSol has made increasing profits on its operations. Nevertheless, emerging problems might slow down its expansion. BancoSol is charging an interest rate higher than that charged by other NGOs, which might weaken its position vis-à-vis these NGOs. It may face difficulties in future to attract and keep qualified personnel at salary scales which are much lower than those of other commercial banks. There are also doubts about its commitment to the micro-enterprise sector, if it is to reach the desired levels of profitability: BancoSol might be tempted to increase its average loan size in order to increase profitability.

5. Rural Banks

61. The most famous example of successful rural banks is the KUPEDES Unit Desa System of Indonesia. KUPEDES, a credit programme for small rural

enterprises, was introduced in 1984; it is run along commercial lines by the Bank Rakyat Indonesia (BRI) through village units called "Unit Desa".

62. Although relying on funds provided by the Central Bank of Indonesia, BRI has gradually stepped up its domestic resource mobilization. Savings deposited within the Unit Desa have increased substantially.

63. KUPEDES charges commercial interest rates which cover the costs of funds, administrative expenses, risk premium and still allow a surplus. Arrears are low, at less than 5 per cent of outstanding loans. Credit delivery is decentralized and transaction costs are low for borrowers. However, the amounts lent are small, which reduces the impact of lending on employment and enterprise growth.

64. KUPEDES has proved that a credit programme for small rural enterprises on commercial terms can be financially viable and can attract borrowers. In most rural parts of Indonesia, the Unit Desa is the only commercial credit institution to which very small enterprises have access.

6. Equity and Venture Capital

65. The existence of a market for risk capital would allow enterprises to diversify sources of finance and also to reduce the cost of capital, while maintaining a healthy financial structure through reasonable levels of debt/equity ratios. To date, about 50 developing countries and countries in transition have established stock markets. However, only large companies have access to these markets, because of strict disclosure and listing requirements which only mature companies can meet.

66. In industrialized countries, the needs of smaller companies to raise risk capital to finance start-up or expansion operations have been addressed through the creation of second-tier stock markets or informal arrangements to provide venture capital. Second-tier stock markets, with lower listing requirements and less demanding size and reporting thresholds, allow smaller firms to raise equity capital and are usually seen as an appropriate exit mechanism for venture capital investors wishing to capitalize and realise their gains.

67. A number of venture capital funds have been established in OECD countries to make equity investments in smaller companies that have good prospects for substantial growth over the medium term and need a relatively high initial investment.[9] Venture capital has been used to a great extent to finance high or new technology projects. In most countries, banks and large corporate investors have been the main source of investment; even today many venture capital companies in Europe are subsidiaries of major banks. However, institutional investors such as pension funds and insurance companies are increasingly active on the markets and have set up their own venture capital firms or funds. There are also private individuals or groups who see venture capital funds as an attractive investment with high potential returns. In practice, venture capital is invested in a small number of "start-up" projects, but more frequently in expansion and development projects, because of the high risks and high failure rate of new projects.

68. As returns on investments in the form of dividends are not forthcoming or not adequate in the short term, the main objective of venture capital investors is an early "exit" from their investments through share redemptions at good prices. Generally the timing of the share sale or "exit" is included in the original investment agreement and may range from three years to 10 years. Although a stock exchange listing is the most desirable way to sell shares, this is rarely a feasible option for small firms. In some countries, there exists an exchange mechanism of unlisted securities through "over the counter" share trading of small companies. More often shares are sold to the partners or through a "trade sale" to an outside firm or other investors. The most serious problem in "exit" arrangements is to determine the right price of shares.

69. Experiences in developed countries have shown that venture capital funds have not generally been very profitable, because of the scarcity of good projects, high risks and difficulties to "exit". Many of these funds have diversified their investments which are not only in small business but also in medium-sized enterprises. Furthermore, as venture projects need not only equity funding but also working capital, success could be better assured by a syndication of equity financing funds which put together packages of all the financing needed (equity as well as loans) and then maintained some control on management. Equity funds for small business with a major developmental orientation should have their administrative or operational costs covered by a grant from governments or external donors.

70. Developing countries have also accumulated venture capital. In Asia, such countries as India, Indonesia, Republic of Korea, the Philippines, Singapore and Taiwan Province of China have set up venture capital funds.

71. In India, the Technology Development and Information Company of India Limited. (TDICI) was established in 1987 by the Indian Development Bank and the Unit Trust of India (a commercial banking organization). In 1988, the Bank of India issued guidelines, limiting the operations of venture capital to investments in small and medium-size industries in high or new technology sectors. In 1989, the Credit Capital Venture Fund (CVF) was jointly established by Credit Capital Finance Corporation (a leading merchant bank), the Bank of India, the Asian Development Bank and the Commonwealth Development Corporation. In addition, two state development finance institutions established Gujarat Venture Capital Limited. and APIDIC Venture Capital Limited. Another venture capital fund, the Risk Capital and Technology Finance Limited (RCTF), was created to provide "seed capital" to finance the development of projects before the commercial development stage. Venture capital companies in India provide equity finance and conditional loans. Conditional loans are those repaid by revenues and royalties generated by the projects. Until end-1992 none of the investments made by venture capital companies had reached the divestment stage, therefore any problems of "exit" options and evaluation of shares had not yet arisen.

72. In the Republic of Korea , following the adoption of the Small Business Start-up Promotion Act in 1986, some 15 venture capital companies were created; by the end of 1992, the number of such companies had increased to 58. In 1986, the Government created a "start-up" promotion fund which was administered by the Small and Medium Industry Promotion Corporation. The fund made loans to or invested in venture capital companies, as well as in venture investment partnerships.

73. Venture capital companies invest mainly in unlisted SMEs and expect to realise capital gains when the companies go public. An "over the counter" market was established in 1987. Investments are made in technology-intensive manufacturing companies with high growth prospects and high expected profits. Venture capital companies also enjoy many tax incentives.

74. As these companies tended to be conservative and encountered difficulties in finding appropriate investment projects, they became increasingly involved in other activities such as lending, leasing and factoring. It has been found that the pay-back period for venture capital investment was more than ten years.

75. In Mexico, a government trust fund, the Fondo de Fomento Industrial (FOMIN) was established in 1972 and administered by the major National Development Bank. FOMIN's role is to help newly created SMEs or existing ones through a minority contribution to their equity capital. FOMIN offers a combined package of equity and loans. Valuation of assets to be divested has proved to be a major problem, especially in an inflationary context. In addition to FOMIN, a number of private venture capital companies have been formed.

76. International venture capital funds have also been created by donor institutions for investments in developing countries. One such fund is the *Société d'Investissement et de Développement International* (SIDI), based in Paris and founded by the French Catholic Committee against Hunger and for Development, together with *Epargne solidarité développement* (a grouping of industrialists, religious congregations and associations) and *Caisse centrale de coopération economique*.[20] SIDI takes equity participation in local investment and financing companies in developing countries. Through these local companies, SIDI invests as a minority shareholder in SMEs which have high potential for growth and profitability. SIDI aims to sell its shares within five years, although it has incurred losses from many of its investments. SIDI combines equity investment with loans to individual enterprises in which it invests.

77. The French *Caisse centrale de coopération économique* established, in 1977, the *Société de promotion et de participation pour la coopération économique* (PROPARCO), originally conceived as a venture capital company investing in SMEs in Africa and providing technical advice to these enterprises.[21] Over the years PROPARCO shifted its activities from investing in start-up projects to participating in the expansion of capital of existing enterprises. The low profitability of its investments and high rates of failure of projects had forced PROPARCO to reorient its activities and to focus on lending to SMEs.

78. The Commonwealth Development Corporation started to help develop venture capital operations in developing countries in 1987, mostly in Africa.

C. Informal finance

79. Alongside the formal financial system, there exists in most developing countries, and particularly in the poorer countries, a dynamic informal financial sector which undertakes mobilization of savings as well as extension of credit.[22] The existence of this informal sector poses policy challenges to Governments, as their activities often do not imply any legal status and, thus, escape regulatory control, whether by the Central Bank or fiscal authorities.

80. Financial dualism affects economic development through the dichotomization of resource accumulation and distribution processes. Sectoral and regional disparities are created with respect to the mobilization and allocation of funds; this results in a growth rate differential between sectors, as their development depends on their access to different sources of credit.

81. Therefore, it is important to study the functioning and distribution of these informal financial activities, with a view to understanding the complementarities between formal and informal financial sectors and for finding ways and means to link the two sectors, so as to increase the availability of finance for development, while minimizing costs.

82. The informal financial sector - often characterized by flexibility and speed, but also by high costs of transactions - responds to the needs of those segments of the population excluded from the formal sector or wishing to take advantage of the services offered by the informal sector. Thus, its clientele includes people who do not have access to formal finance because of their low level of income, those who do have access to formal sources but nevertheless seek to supplement bank loans with informal borrowing or to take advantage of the speed of delivery of informal credit or to better integrate themselves into their community. By and large, SMEs, and particularly micro-enterprises, form the core of this clientele. Small borrowers or new borrowers proposing risky ventures or possessing few assets to offer as collateral or for whom speed of credit delivery is essential have recourse to informal sources of finance.

83. It is a well-known fact that the cost of informal finance is often exorbitantly high. Accurate estimates of interest rates on informal markets

do not exist; however, there are indications that these rates can be as high as 100 per cent per annum or more. A survey undertaken in 1975 gives the following estimates of interest rates in the formal and informal sectors in a number of developing countries (see Table 1).

Table 1. Real interest rates per annum in selected countries, 1975

Country	Informal Sector	Formal Sector
Nigeria	192	-2
Ivory Coast	145	6
Sudan	120	7
Bolivia	96	5
Ethiopia	66	8
Ghana	64	0
Sierra Leone	60	-3
Malaysia	58	16
Mexico	57	7
Chile	52	-16
Republic of Korea	49	5
Colombia	40	16
Brazil	38	-7
Honduras	37	6
Indonesia	29	3
Pakistan	27	4
Costa Rica	20	4
Sri Lanka	20	-1
India	15	-1

Source: From Steve Haggblade, CarlLiedholm and Donald C. Mead. "The Effect of Policy and Policy Reforms on Non-Agricultural Enterprises and Employment in Developing Countries: A Review of Past Experiences", in Stewart *et al.*, *The Other Policy: The Influence of Policies on Technology Choice and Small Enterprise Development*(London: IT Publications, 1990).

84. The rate differential between the two sectors could be partly justified by the fact that informal lenders take up riskier projects and that the opportunity cost of funds is higher for them.

85. The informal sector usually makes small loans of very short terms, which in general are more expensive than long-term loans bigger in size. Clients of the informal sector are small or micro-enterprises or poor individuals, who carry higher risks than clients of the formal sector. While the opportunity costs of funds may also be higher for individual money-lenders, however, the transaction cost of lending in the informal sector is lower than in the formal sector, which has to incur high intermediate input and administrative costs, to acquire information about borrowers, to monitor loans and fiscal charges. On balance, then the high interest rate of the informal sector might result more from the monopoly position of informal lenders, because small borrowers seldom have other alternatives.

86. Despite the absence of any regulatory framework and the minimum collateral requirements, the informal sector exhibits lower default rates. Closer screening of applicants and stricter monitoring of loans may explain this result. The proximity of residence and work place of lenders and borrowers may enable the former to obtain information on the true financial situation of their clients and to monitor continuously their whereabouts and business activities. Pressure by other members of the community ("peer pressure") on bad payers to force them to pay in order to preserve the creditworthiness of the community is also effective in exerting discipline on debtors.

Classification of informal financial activities

87. The informal sector is heterogenous and reflects a wide variety of links between lenders, borrowers and depositors, ranging from simple credit arrangements to complex financial intermediation mechanisms. The following classification is provided by J. Holst[23] and adapted by Germidis.[24] (See Table 2.) Three types of informal lenders are generally distinguished:

- Individual money-lenders;
- Groups of individuals organized mutually;
- Partnership firms.

88. Individual money-lenders lend from their own funds; they can comprise friends, neighbours, relatives, landlords, agricultural input dealers, professional money-lenders, traders, equipment suppliers,etc. Mutual associations include fixed fund or rotating savings and credit associations (ROSCAS), informal credit unions, savings clubs, mutual aid associations, self-help organizations,etc. Partnership firms include local bankers and pawnbrokers, or finance companies.

Mutual savings and loan associations

89. Savings and credit associations exist in most developing countries, in urban and rural areas, among traders and market-women,farmers,fishermen, small industrialists, wage and salary earners, even among bankers. They start with savings accumulated to help each other in case of an emergency and distribute money in a rotation order. These associations then shifted towards purely financial institutions for savings and credit rather insurance purposes. Recently, many savings and credit associations have expanded their activities, providing various financial services,mainly to members, and sometimes to non-members, for the purpose of house building, social insurance services for medical treatment and other expenditures.

90. The basic structure of these associations is the same: a group of people with a common bond-extended family members, friends, residents of the same village or district, workers in the same office or firm, etc. pool together their savings in order to benefit from credit facilities in view of expenditures which they cannot assume on their own, or for mutual aid in case of emergencies. Each member pays in a fixed amount at regular intervals. In a rotating and credit association (ROSCA), part of the sum collected is allocated to each member in turn in rotation; the rest is kept in a general fund for loans, emergency insurance, etc. In a simple rotating savings association, each member receives in turn the whole amount of funds collected.

91. Almost all mutual savings and credit associations are governed by their own rules and regulations or constitution. There are usually three primary functions: savings, loans and insurance. Less frequently there may be additional economic functions, such as reciprocal labour, joint production or other forms of common investment.

92. Loans are generally on a short-term basis, with maturities running from one week to several months. Interest is charged on loans, at market rates. Loans are frequently secured through one or several guarantors, who stand in with their savings if loans are overdue, or through depositing some specific collateral. The risk of default is minimal, although default might occur if the group's officers (especially the Treasurer) are dishonest or if the early recipients of the fund subsequently disappear.

Table 2. Informal savings and credit arrangements

	TYPES OF LINKS	LENDERS	BORROWERS
INDIVIDUAL MONEY-LENDING	Non-commercial arrangements	Friends Neighbours Relatives	Small farmers Small businesses and households
	Commercial credit arrangements		
	i.Money-based	Professional moneylenders, mobile bankers, private individuals from upper-income groups	Small farmers Small businesses and households
	ii. Land-based	Landlords farmer-moneylenders	Tenants
	iii. Commodity-based	Trader-moneylenders agricultural input dealers, equipment suppliers, processors (rice millers), produce traders, itinerant traders, market vendors, store owners	Small farmers Small business and households
ASSOCIATIONS	Savings arrangements	Fixed-fund associations, mutual aid associations, saving clubs	Small farmers, Small business and households, Small farmers and households
	Combined savings and credit arrangements	informal credit unions, informal savings and loan co-operatives, ROSCAs (and variants)	Small farmers, Small business and households
PARTNERSHIP FIRMS	Financial intermediation	Indigenous bankers, pawnbrokers, finance companies.	Small business and households

Source: adapted from Juergen U. Holst, "The Role of Informal Financial Institutions in the Mobilization of Savings" in Kessler and Ullmo, eds., Savings and Development (Economic, Paris, 1985).

93. The basic principle of ROSCAs to link credit with savings has many advantages. It allows the low income individuals or small entrepreneurs to pool together their small savings and obtain a larger credit. The fund thus collected could also be used as collateral to guarantee credit from another financial institution to some members of the association. As borrowers have a vested interest in the financial sustainability of the association, they will be motivated to repay their loans. There is thus a relationship between savings and higher repayments of loans.

94. These informal associations may also establish linkages with formal financial institutions either for savings activities or credit operations. Thus, savings associations can deposit the funds collected with a bank, either directly to earn some interest income or to use as a collateral for obtaining credit to the group or members thereof. Such linkages can be the first steps to make individual small enterprise borrowers bankable clients and help them to gain direct access to formal financial institutions. These linkages may take the form of either direct contact with banks or indirectly through the intermediation of NGOs or other public agencies. Very often the lack of legal status is an obstacle for informal savings organizations to establish links with formal financial institutions. This problem can be overcome by giving these associations the status of cooperative societies, foundations, voluntary associations or even business enterprises which can be legally registered. Linkages can be done through an NGO or public organization which then takes legal responsibility.

Partnership firms

95. This group includes "semi-formal" financial companies which lend out funds collected through deposits of the public's or the proprietors' own funds. Such companies could be made to submit to government regulations which could be in any case much less restrictive than those of formal financial institutions. Indigenous banks, mostly found in rural areas, are very often run by a sole proprietor who accepts deposits and provides loans. They differ from formal banks by the flexibility of their terms and procedures.

96. Pawnbrokers lend money at (high) interest on the security of the value of goods left with them. Although the interest rates on loans from pawnbrokers are higher than those of banks, this form of lending offers ease of access, quicker service, easier valuation procedures.

97. Finance corporations are financial intermediaries set up in partnership between several founders, raising money through deposits for on-lending. The number of partners usually does not exceed ten. The initial funds for the business are contributed by the partners as subscription capital. Deposits are usually accepted for a long period, from one to several years. Borrowers are closely canvassed by partners and loans are made only to persons recommended by, or known to, at least one of the partners. Both the deposit and lending rates are higher than those of commercial banks.

III. MEASURES TO ENHANCE SMES' ACCESS TO FINANCE

General Observations

98. A number of general observations maybe made after reviewing the systems of financing of SMEs. First, the problem encountered by SMEs in securing adequate finance is normally linked to the level of development of the financial system. In a less developed, less diversified system, SMEs' needs for finance, and especially long-term finance, are often not met by the formal commercial system. In contrast, a competitive financial system, where competition between banks would reduce their reluctance to lend to SMEs, would allow easier access to finance.

99. Lending to SMEs entails high transactions costs, owing to various factors. The costs incurred to acquire the requisite information, to

monitor loans and follow up projects can be very high, given the fact that it is not easy to obtain information about small borrowers who are either inexperienced in project preparation or sometimes reluctant to provide the required information. Taking into account transaction costs, the small size of the loans often does not allow a worthwhile margin of profit for banks.

100. SMEs are heterogenous; their financial requirements vary according to their size, activities and location. For example, micro-enterprises need short-term financing, in small amounts. Their financial needs are often not separable from the personal or family financial needs of the entrepreneur. In these cases, the speediness of credit delivery is highly appreciated; and a system of retail credit might be more appropriate. For other types of SMEs involved in more "modern" activities, financial requirements could be linked to the need to expand activities, to upgrade technology, or to overcome shortages of working capital. Requirements for equity injection and long- or short-term credit vary accordingly. Linkages with large enterprises can ease access to finance.

101. Some lessons can be usefully drawn from lending practices in the informal sector. First, the linking of savings with credit provision can effectively replace the provision of other collateral in reducing the risk of default. Secondly, collective guarantee and "peer pressure" reinforce the debt repayment discipline.

102. SMEs, taken individually, are economically and financially weak. They are less well equipped to hedge against market changes and economic fluctuations than large enterprises. They are therefore considered as risky borrowers. Such weaknesses call for more cooperation among themselves and for government support. Cooperation in the form of clustering of units in industrial districts or other forms of groupings can bring benefits of economies of scale and reinforce their collective bargaining power with banks (for example by collective guarantees on loans). On the other hand, the experiences of more developed countries have shown that government intervention is often needed to enhance SMEs' access to finance.

Support measures

103. The government has a vital role to play in ensuring a favourable financial environment for SMEs, not only by implementing adequate economic policies to promote growth, but by giving special incentives to encourage lending to SMEs and by making available to small business sufficient amounts of low-cost funds. The actions of the government should aim at reducing the risks and the costs related to lending to SMEs and building up institutions to provide services adapted to their needs.

Bank lending

104. Experiences reviewed in the preceding section have shown that actions need to be taken in three areas: minimizing the costs of lending, reducing the risks and setting mandatory lending limits. As already stressed, the costs of lending to SMEs can be high, owing to the search for information, to administrative costs in handling many small-sized loans and ensuring the follow-up of projects. One way to reduce information costs might be to encourage professional associations of SMEs, such as chambers of commerce, to collect information on would-be borrowers and their branches of activities and make it available to banks. Administrative costs could be reduced by simplifying lending procedures.

105. Very often interest spreads allowed do not fully cover the inherent high transactions costs. It is suggested that even efficient lending to SMEs would involve administrative costs in the 2 per cent to 4 per cent range, a figure that would not cover losses if repayment rates were poor; a spread of 8 per cent or 10 per cent might be justified in certain cases.[25] In order to secure spreads which are high enough to cover transactions

costs, funds either have to be made available to banks at appropriate low cost, or banks must be allowed to lend to SMEs at rates higher than those applied to their known larger customers.

106. Banks reduce their risks of lending to SMEs by requesting collateral. However, risks can also be reduced through credit guarantees or insurance, and through refinancing loans by official institutions.

107. Credit guarantee programmes for SMEs have been reasonably successful in industrialized countries. In developing countries, credit guarantees have also become popular, supported by external donors' contributions. However, most of these schemes have not been very effective in persuading banks to lend to small enterprises. They are either inadequately funded or understaffed so that requests for guarantees and the handling of claims cannot be dealt with expeditiously. Moreover,as with any credit insurance, there is a problem of moral hazard. The existence of guarantee or insurance may encourage borrowers not to repay in full or in part their debt. Therefore, borrowers should be asked to share the insurance fees. The possibility also exists that the lending institution will feel no real commitment in appraising and approving the loan and in collecting debt if the institution does not have to bear the risk of non-repayment. There is also the risk that banks might use the scheme only for the riskiest of borrowers. Finally, it has been noted that despite the availability of guarantees, banks continue to request collateral from borrowers.

108. Some countries such as India, Republic of Korea, Pakistan, Malaysia and Indonesia have imposed minimum quotas of loans to SMEs in their overall portfolio. These directives do help to increase bank loans to SMEs. However, their impact should be judged in the light of the general financial environment and the ability to monitor the system. Mandatory limits should be set at levels which do not jeopardize the financial health of banks or deprive viable larger enterprises of necessary funding.

Institution building

109. There are two areas where special institutions may need to be set up to respond to the needs of small business: the provision of long-term finance and retail lending to micro-enterprises.In developing countries, the banking system provides mostly, if not exclusively, short-term finance. To fill the gap for long-term financing, Governments have set up development banks and special financial institutions to provide long-term loans to SMEs. These institutions have a rather low level of profitability and have to rely continuously on low-cost funding by governments or external donors, thus limiting their ability to lend. Thought might be given to ways to increase the profitability of these institutions, by increasing the interest rates charged, and allowing them to take deposits. Lending at low subsidized rates might lead to the erosion of the original funds. In addition, borrowers could be less motivated to repay subsidized loans, preferring to pay off more costly credits first.

110. Another source of long-term finance could come from equity investments. Experiences of funding SMEs through equity or venture capital are scarce and have not proved successful, very often because it is not easy to exit from these investments by selling shares. Consideration could be given therefore to establishing over-the-counter markets or clearing houses to facilitate such transactions.

111. Experiences on retail lending to the poor have been quite positive, with the establishment of savings banks, such as the Grameen Bank and BancoSol. The linkage between savings and credits has proved to be a sound practice which helps to increase finance to micro-enterprises.Channelling very small loans through formal institutions helps to reduce interest rates charged, especially if these institutions benefit from low-cost funding by donors.

Ancillary services

112. Promotion of viable SMEs requires the provision of other services besides finance. SMEs also need information, guidance and advice if they are to make the most effective use of finance.The technical assistance provided should be tailored to the particular needs of enterprises being assisted. There is often a problem in coordinating financial and technical assistance. Promotional institutions and technical assistance agencies have difficulty in gaining the confidence of financing institutions. Banks are often reluctant to rely on the selection and evaluation of projects recommended by these agencies. Although there is no clear conclusion about the most suitable organizational relationship between technical assistance and financial services, it is perhaps desirable to have separate institutions and to involve the private sector through associations of small industrialists, chambers of commerce, etc.

IV. CONCLUSIONS

113. Adequate access to finance is critical for the development and expansion of SMEs. However, the supply of credits from the formal financial sector is scarce, given the reluctance to lend to SMEs because of the perceived high risks. Informal finance is available, but on very small scale and at high cost. In these circumstances, Governments can play a useful role in reducing the risks and costs of lending, by providing credit guarantees or insurance, making available to banks refinancing facilities or imposing reasonable lending quota limits. Governments, through provision of low-cost funds,can also help set up specialized financial institutions to provide long-term finance to SMEs or retail loans to micro-enterprises.

114. However, as government resources are limited, their cost-efficient use would require that the assistance provided to SMEs be well integrated into the overall industrial policy of the country, aiming at assuring the viability of SMEs and strengthening their development. In this respect, Governments needs to have clear ideas about target groups and their specific need, as well as encouraging backward and forward linkages between enterprises. The usefulness of schemes which link savings with credit supply could be further explored, especially as SMEs have amply demonstrated their capacity to save through the financing of their enterprises by their own resources.

115. As the economy grows and the financial system is deepened, made more diversified and competitive, SMEs' access to finance will also become easier and there will be less government involvement in enhancing this access. Efforts to develop a viable domestic financial system could yield great benefits for the small business sector in particular.

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Notes

[1] It is reported that industrial policy in the Republic of Korea was much concerned with the prevention of "excessive competition". In order to arrive at optimal production scales, the Government favoured large enterprises in priority sectors through deliberate measures including restrictions on entry and capacity expansion, state-initiated mergers, coordinated capacity scrapping and /or exit, and market-sharing arrangements. See Ha-Joon Chang: "The political economy of industrial policy in Korea", in Cambridge Journal of Economics, Vol. 17, No.2, June 1993.

[2] See J.C. Sandesara: "Small-scale,Industrialization: the Indian Experience", in H. Thomas, F. Uribe-Echevarria and H. Romijn: Small-scale Production, (IT Publications, London, 1991).

[3] See: M. Giaoutzi, P. Nijkamp and D.J. Storey, eds : Small and Medium-sized Enterprises and Regional Development (Sage, London, 1987); A. Portes, M. Castells and L.A. Benton, eds: The Informal Economy- Studies in Advanced and Less developed Countries (John Hopkins University Press, Baltimore,1989). Although examples abound in developed countries on the possibilities offered by flexible specialization process for SMEs' production, especially through efficient agglomerations of small-scale producers, the situation is less clear in developing countries. There have indeed been such successful production networks of small producers in more advanced developing countries such as Taiwan Province of China, Hong Kong and Singapore, experiences in other developing countries are less known and documented.

[4] The discussion on different types of classification is largely based on Francisco Uribe-Echevarria: "Small-scale Industrial Development- A Policy Statement" and J.C. Sandesara: "Small-scale Industrialization: the Indian Experience", in H. Thomas et al. : Small-scale Production, op.cit.

[5] See F. Uribe-Echevarria, op.cit. , p.27.

[6] However, this simple classification does not reflect the industrial organization of a country and, thus, is not very useful for designing promotion policies compatible with an overall industrial strategy.

[7] Such a classification has been is suggested by Sandesara, in the light of the Indian experience on promotion programmes for SMEs; see Sandesara, op.cit.

[8] The Government of the Republic of Korea enacted, in 1975, the "Small Industry Subcontracting Promotion Act" aimed at promoting closer linkages between large and small firms through subcontracting. Products judged especially appropriate for production by SMEs are reserved exclusively for them. The aim is to enhance growth, competitiveness and specialization of suppliers in each industry. Furthermore, the Korea Credit Guarantee Fund provides credit guarantees, credit information, managerial and technical assistance mainly to those SMEs which are recommended by their large corporations partners as reliable and soundly-managed suppliers. For more information, see: Nam Dae Woo: "Linkage between large corporations and small and medium enterprises", in SMEs towards 2000, edited by C. Agrawal (World Assembly of Small and Medium Enterprises, New Delhi, 1993).

[9] The difficulties of SMEs seeking to borrow from banks are well known; see in particular: Jacob Levitsky: "Financing of Small and Medium-Scale Enterprises", in Financing of Small and Medium Enterprises, edited by Chakradhari Agrawal (World Assembly of Small and Medium Enterprises, New Delhi, 1993.

[10] C. Ruiz Duran: "Financing Small and Medium Enterprises in Latin America", UNCTAD/GID/16, Background paper presented at the second session of the Working Group on the Role of Enterprises in Development, July 1995.

[11] For more details, see Ruiz Duran, op. cit.

[12] See J.Levitsky, op.cit., Table 1, sources of finance for initial investments by small enterprises in some African countries.

[13] Asian Development Bank: The Role of Small and Medium-Scale Manufacturing Industries in Industrial Development, The Experience of Selected Asian Countries (Manila, January 1990).

[14] See Bae Kyung Il: "Financial Liberalization and the Financing of Small Business: The Korean Experience", in C. Agrawal,ed., op.cit.

[15] See: Joseph Nsereko: "The role of financial and other support institutions in the development of cottage and small industries in Africa", in C. Agrawal, ed. Financing of small and medium enterprises, op. cit.

[16] This section draws heavily from the article by J. Levitsky: "Financing of Small and Medium-Scale Enterprises", op.cit.

[17] Information on the Grameen Bank comes from the study prepared by Jacob Levitsky for the International Labour Organisation: Innovations in the financing of small and microenterprises in developing countries (International Labour Organisation, Geneva, 1993).

[18] Information on Banco Sol is found in the article by Amy J. Glosser: "The creation of BancoSol in Bolivia", in: The New World of Micro-enterprise Finance, edited by Maria Otero and Elizabeth Rhyne (Intermediate Technology Publications, London, 1994).

[19] On venture capital, see: OECD: Venture Capital, context, development and policies (OECD, Paris,1986); Jacob Levitsky: "Venture Capital for Small Enterprises", a discussion paper for Overseas Development Administration , January 1994 (reprinted in World Association for Small and Medium Enterprises, Small Enterprises Series-4, 1994); Financial Times, 23 September 1994: "Venture and Development Capital".

[20] For more information, see Jean-Paul Vigier: "L'expérience de la SIDI ou les risques du tout petit", Epargne sans frontière, No.18, mars 1990.

[21] On PROPARCO, see: François Colas : "Conseiller, financer et risquer: L'évolution des stratégies d'intervention de PROPARCO en Afrique", Epargne sans frontière, No. 18, mars 1990.

[22] On informal finance, see in particular: D. Germidis, D. Kessler and R. Meghir: Financial systems and development: What role for the formal and informal sectors? (OECD, Development Center, 1989); Prabhu Ghate: Informal finance, some findings from Asia (Asian Development Bank, 1992).

[23] Juergen U. Holst: "The Role of Informal Financial Institutions in the Mobilization of Savings", in D. Kessker and P.A. Ullmo, eds. Savings and Development (Economica, Paris, 1985)) and adapted by D.Germidis et al.

[24] D.Germidis et al.: Financial systems and Development, op. cit.

[25] See J. Levitski: "Financing of Small and Medium-Scale Enterprises" , op.cit.

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Item 4 of the provisional agenda

IDENTIFICATION OF AREAS WHERE TECHNICAL COOPERATION IN SUPPORT OF POLICY DEVELOPMENT TO ENHANCE THE ROLE OF SMALL AND MEDIUM-SIZED ENTERPRISES COULD BE STRENGTHENED

Technical cooperation for policy development to enhance the role of small and medium-sized enterprises

Report by the UNCTAD secretariat

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Introduction

1. The Trade and Development Board, by its conclusions and decisions 415 (XL), established the Ad Hoc Working Group on the Role of Enterprises in Development. According to its terms of reference, the Ad Hoc Working Group should analyse the interrelationship between the development of a domestic entrepreneurial capacity, in particular for the development of small and medium-sized enterprises (SMEs), and the development process. Particular attention should be paid to the situation of the least developed countries. Particular topics identified for analysis should include: (i) the role of the State in creating an enabling environment for the promotion of entrepreneurship and the viable development of enterprises, with reference to the regulatory framework and incentives structures, human resources development, institution building and institutional support and the informal sector and its integration into the formal economy; (ii) export development and the role of SMEs, giving due attention to the possible advantages arising from the globalization process; (iii) interactions between the development of SMEs and of capital markets and banking systems, with reference to the generation of domestic savings and access to capital markets and other sources of financing; and (iv) identification of areas where technical cooperation in support of policy development to enhance the role of SMEs could be strengthened. The Ad Hoc Working Group should provide a forum for the exchange of experiences among member States so as to enable them to draw appropriate lessons for the formulation and implementation of policies at the national and international levels and for international economic cooperation.

2. This report has been prepared by the UNCTAD secretariat in order to facilitate consideration of topic (iv) mentioned above. This and topic (iii) will be considered at the second session of the Ad Hoc Working Group, scheduled to be held in Geneva from 3 to 7 July 1995. The first two topics were considered at the first session, held in Geneva from 3 to 7 April 1995. The report draws on, inter alia, studies of country experiences, including those submitted by Governments in response to a questionnaire prepared by the secretariat, from the following countries: Bolivia, China, Costa Rica, Ethiopia, Germany, Guinea, Indonesia, Kenya, Lithuania, Malaysia, Mauritius, Norway, Romania, Turkey and the United Kingdom.

3. The report raises and discusses policy issues which can be the subjects of useful cross-country exchanges of lessons learned and insights gained from national experiences, thus enabling policy elements to be derived for the formulation and implementation of policies at the national and international levels and "best practices" to be identified. Every effort has been made to build on the issues raised during the discussions at the first session on the topics of the enabling environment, and supportive policies, for SME and export development.

4. This report addresses areas of policy development to enhance the role of SMEs in the development process where technical cooperation may be strengthened. These include policy issues relating to (i) the creation of favourable framework and market conditions for SME development (including market failures, legal and regulatory constraints to market and enterprise development and institutional support for SME development); and (ii) networking and modernization of SMEs, as well as regional cooperation on SME development.

I. Creating favourable framework and market conditions

5. The State has a role to play in creating favourable framework and market conditions for the development of entrepreneurship and of enterprises, including SMEs. This implies the creation of a favourable macroeconomic framework for creating business confidence and reducing commercial, financial or investment risks associated with unexpected or sharp tax, interest rate or currency movements. Such conditions, together with appropriate Government support and financial markets regulations, will help to mobilize savings, develop financial institutions and markets and encourage investment, including foreign investment. Macroeconomic stability will also facilitate structural adjustment, including any industrial restructuring, designed to achieve more open markets and competitive enterprises. Thus, it is important that support programmes for SME development be properly designed and contribute to productive activities, so that they will be fiscally neutral and not undermine macroeconomic stability.

6. In addition, there is a need to create a sound policy and commercial framework for business development, in which markets can function efficiently, through the adoption of appropriate policies, including those relating to factor markets, the organization of the firm and support services, product markets and intellectual property, environment and standards. Such policies range from price deregulation, promoting greater flexibility and mobility in labour markets, development of financial markets and institutions, promoting competition to policies concerning human capital and infrastructure development. At the same time, the commercial framework -- including rules, laws and regulations governing the establishment and operations of companies, market entry and exit, as well as legal enforcement procedures -- needs to be clear, stable, predictable and effective.

7. These "framework conditions" -- macroeconomic stability and sound policy and commercial framework -- are especially vital for SME development, given their relative weakness vis-à-vis the stronger players. As a general rule, they should apply to all companies irrespective of size. However, because of the limited resources of SMEs, certain administrative rules (for example, for the registration of companies) may be simplified and made less time-consuming at little or no cost for small businesses, including micro-enterprises, in order to facilitate their registration and to encourage business start-ups. Furthermore, tax payment procedures may be simplified for small businesses by levying a small lump-sum tax without the need for the filing of tax returns or the keeping of detailed accounts - a system used, for example, in India.

8. Where the State succeeds in creating an environment that enables markets to function properly and efficiently, so that SMEs are not disadvantaged because of their size in relation to large enterprises, the best policy towards SMEs may be one of "maximum openness, minimum intervention". However, it is recognized that there may be instances where SMEs may need to be provided with particular assistance by the State. This need may arise where the cost of compliance, for example with environmental standards, or the increased cost of capital due to bad macroeconomic management is disproportionately higher for SMEs than for large enterprises. Furthermore, in Japan, subsidized loans by financial institutions created to cater to the needs of SMEs are provided in special cases, such as the modernization of production facilities, the relocation of plant or the conversion of business activities due to structural change. In any case,

the State, if it cannot be helpful, should at least refrain from making business activity difficult for SMEs by over-regulating or over-taxing them or by favouring large enterprises at their expense, which may in the process force them out of business.

9. However, where there are market distortions or failures, for example, where markets or inter-firm networks are controlled by dominant incumbents or where policies favouring large enterprises or the inefficient functioning of product, financial or other markets result in high cost, low quality or unavailability of essential inputs for SMEs, so that newcomers or SMEs cannot compete on a equal footing, the State may need to intervene to help the latter by taking measures to correct or eliminate market deficiencies. One such measure is a loan guarantee programme which can play an important role in changing the attitudes and practices of commercial banks, thereby increasing the access to credit for SMEs. In this context, consideration needs to be given to minimizing the risk of moral hazards. In some of the transitional economies, the restructuring of large enterprises into smaller, competitive and flexible firms has assumed a particular importance. However, such support for SMEs should be limited to creating a "level paying field", with the ultimate objective of fostering competitive enterprises in domestic and foreign markets.

10. Market failures are not just a matter of deficiencies in financial or other markets. The lack of communications infrastructure, including roads and telecommunications, causes other forms of market failure. Telecommunications is in fact the lifeline of business activity: markets cannot function without effective flows of information. It is hardly possible to conceive of networking, so essential for the development and modernization of SMEs, without adequate telecommunications. Subcontracting cannot be extended to SMEs in rural areas without adequate roads to such areas. Likewise, the lack of an educated labour force, or of entrerpreneurial and other skills needed for the business world, may also have a constraining effect on efficient market development.

11. Improvement of the legal and regulatory framework in which SMEs operate may also be necessary. This may involve removing or easing regulatory constraints, as in many developed and developing countries, or improving the overall legal framework governing business activities, as in many countries in transition, where the commercial framework is characterized not only by a lack of basic laws but also by a lack of consistency and stability in the existing laws. Regulatory constraints act on SMEs in different ways, for example by imposing barriers to entry to their operations (thus restricting competition) and by imposing a cost for business start-ups and development. On the other hand, inconsistencies and gaps in the overall legal framework, or lengthy or unpredictable legal enforcement procedures, can also act as impediments to SME development. A recent study stated that Government barriers to competition rather than labour market rigidities explain why recent employment creation has been lower in the European Union than in the United States and Japan (1). It has been noted that, in Italy, the absence of Government involvement in the development of SMEs (other than recent legislative measures to reduce restrictions on small firms), together with a policy of not actively levying taxes and payments of national insurance contributions on such firms, has created a considerable degree of independence and self-reliance among SMEs and fostered rather than hindered their development (2).

12. "Regulatory failure" may also help to explain why many micro-enterprises are associated with the informal sector and why the informal sector, rather than receding, is in fact growing in some

countries, such as Brazil. Understanding the reasons, and in particular the role played by the legal and regulatory framework, can help to shape policies that can assist micro-enterprises in the informal sector to grow or to graduate to the formal sector without destroying their important economic and social role, including the empowering of women in the process of development, or worse still forcing them into illegal activities, while recognizing that not all such enterprises wish to grow or to join the formal sector. Various kinds of measures may be taken for this purpose, including providing finance and physical facilities, as well as simplifying registration procedures and reducing the cost of administrative compliance. The creation of physical facilities for micro-enterprises in the informal sector can help to formalize their operations as well as provide them with stability and the type of environment which facilitates their access to credit and productive assets. In the final analysis, programmes to promote basic education and to raise skill levels may be the most effective way of helping them to be integrated with the formal sector. Investment in such programmes can bring long-term benefits in terms of strengthening entrepreneurship, increasing competition and enlarging tax receipts.

13. Many countries, recognizing the importance of the role played by SMEs in industrial and export development, particularly in the context of a globalizing and liberalizing world economy, have adopted proactive policies, together with institutional support, for the development of SMEs. Various Governments, as in Canada, France, Indonesia and United Kingdom, have even established Ministries or Departments for Small Business to act as a catalyst or a "lightning rod" for Cabinet-level policy development in support of SMEs.

14. Such institutional support needs to be seen as an exercise of partnership or of consultation between the Government and the private-sector, and needs obviously to involve SMEs and their organizations. This will ensure that (i) the organization of support services is market-based, i.e. they complement or encourage, rather than duplicate, private-sector initiatives or services and, where appropriate, compensate for market deficiencies and thus help to enhance the availability and effective utilization of essential inputs for SMEs, such as finance, physical facilities and equipment, training, market information, business advice, export marketing tools and business software packages; (ii) it can encourage, support or facilitate inter-firm cooperation, including in the context of industrial districts and of subcontracting arrangements with foreign firms, so as to increase the skills, flexible specialization, technological capacity, production and trading opportunities of SMEs; and (iii) it gets adequate feedback from the private-sector and SMEs concerning the effects of the framework and market conditions on business activities and possible improvements.

15. Such institutional support is normally located in a lead support agency, under the executive leadership of representatives of both the public and private sectors. However, in some countries, many of the support services are provided by private institutions, such as SEBRAE in Brazil. Coordination of the lead agency's activities with those of specialized institutions - such as in the areas of automation applications, science and technology, information technology, productivity improvement and standards and industrial research - will help to ensure a coordinated or integrated approach to assistance. For example, financial assistance for the purchase of equipment will need to be integrated with technical support for the operation of the equipment, where needed, if assistance is to be effective. In the United Kingdom, the Business Links programme integrates a wide variety of services, ranging from business consultancy to export services, in one-stop centres.

16. In the light of the above, the areas of policy development where technical cooperation may be strengthened may include (i) the policy and commercial framework for business development, with particular reference to SME development; and (ii) institutional support for SME development.

17. Technical cooperation concerning the policy and commercial framework for business development with particular reference to SMEs may take the form of providing to individual countries policy advice or technical expertise in various areas, including, for example, the formulation of proactive policies for SME development or of consistent business laws. It may also take the form of helping individual countries to build up their analytical and research capacity, either in support agencies or in business organizations, to analyse, for example, the causes of market failures, the effects of macroeconomic policies on SMEs, the effectiveness of various types of incentives in relation to their objectives or the impact of business laws and regulations on entrepreneurial and business development, including in the informal sector, as well as to determine modalities for improvement. With regard to the regulatory framework, it may be noted that Norway, for example, has established a Business Legislation Committee for the purpose of analysing the impact of business regulations on market and enterprise development. In addition to strengthening public-sector capacities for policy formulation and implementation, technical cooperation in this area may also be extended to deepening indigenous business management skills and promoting the organizational development of private-sector intermediaries (3).

18. Technical cooperation concerning institutional support for SME development may take the form of contributing to institution building, including support for the establishment of effective support agencies or SME associations, through inter alia training programmes for capacity building and support for networking, including the provision of equipment, in order to allow support agencies or SME associations in recipient countries to link up with counterparts in donor or other countries for the purpose of sharing information, experiences, lessons learned and "best practices" in the area of support for SME development. Donors can also help in the process of a constructive and collaborative policy dialogue between the public and private sectors, through their own contacts and their support for the development of representative business organizations, including SME associations (4).

19. Donors recognize that differentiated approaches may be needed for different categories of countries. As indicated in a report of the Development Assistance Committee, "Middle-income countries in general have well-established private sectors and the basic institutions and markets for producing and selling goods and services. The role will often be to support business-to-business linkages (i.e. transferring capital, technology and management and marketing know-how) and the creation of business networks. Nevertheless, it will be important for donors to continue building local and institutional and technical capacities and helping to create a more favourable environment for initiative and investment in these middle-income countries. Least developed countries, which have fewer and weaker institutions - markets and entrepreneurs and more destabilizing factors, need assistance targeted at improving the enabling environment, strengthening institutions and establishing threshold conditions for business. Countries of the former Soviet bloc present altogether different needs and opportunities: while production skills and basic infrastructure exist, capital is scarce, marketing know-how is lacking, industry is often unable to penetrate and compete on international markets. Further, attitudes and habits more conducive to private enterprise (i.e. risk taking, the concept of private property, the profit motive) are slow to develop." (5).

II. Networking and modernization of SMEs

20. Networking can take place at two levels, that of the firm and that of institutions such as SME support agencies or SME associations. In the current context, inter-firm linkages -- through joint ventures, subcontracting, franchising, establishment of alliances or of cooperative arrangements, both at home and abroad -- are an essential part of the process of modernization of SMEs. They enable SMEs to acquire knowledge of consumer preferences in their export markets, of the workings of the international market place and of the nature of international production and competition. The experience and knowledge gained allow them to adjust, for example by achieving flexible specialization, by improving design and quality, by upgrading technology and by sharing assets or undertaking joint activities in order to achieve economies of scale so as to maintain niche markets or to remain competitive. The role of inter-firm cooperation in industrial districts as, for example, in Brazil, Indonesia and Italy, is also of significant importance in contributing to the achievement of flexible specialization and the modernization of SMEs, as well as to export development.

21. Some donor programmes help to promote inter-firm linkages between domestic firms and firms in developing countries. One example is the Indo-German Export Promotion Project supported by GTZ, the German technical cooperation agency, which helps to build up closer cooperation and supplier relationships between Indian and German firms, not only in traditional sectors like shoes, silk garments, leather goods and gold jewellery, but also in technology-intensive products such as computer software, automobile and bicycle components and castings. Such linkages help Indian firms to establish themselves in German markets and, by exposing them to competitors, export marketing requirements and techniques and new market conditions, including latest information about designs and trends provided by their German partners, also encourage them to embark on new processes and activities, as well as to improve their performance and competitiveness. Further, by maintaining an economic policy dialogue with official policy-makers, the project can contribute to improving the policy and regulatory environment for Indian exporters. By working directly with firms which provide feedback to Governmental institutions and private-sector business organizations, and by indicating what types of export promotion activities are appropriate or possible, the project can contribute towards a bottom-up approach to institution building (6).

22. However, much more can be done in order to encourage SMEs to link up with other firms, either domestically or abroad. There is also a need to encourage SMEs to develop export markets or to branch out abroad. In this regard, the lack of information in a number of areas would seem to be a major factor in inhibiting the development of export markets by SMEs and the growth of their linkages with foreign firms. The areas where information is often lacking for SMEs include: sources and conditions of finance, including export finance; export market conditions, including information on design, quality, packaging and labelling requirements; marketing requirements and distribution networks; patents, trademarks and franchising regulations; subcontracting possibilities; training programmes; modern management techniques; sources and conditions of consultancy services; and calendar of future national and international events, such as trade fairs and exhibitions. SMEs have a particular need for such information, especially about export markets. Unlike large enterprises, they do no have the means to collect information by organizing their own market intelligence networks in foreign countries.

23. The availability of support in the way of timely and relevant information on export market conditions in individual countries, as well as credit facilities, including credit guarantees, training programmes and export advisory and technical services, can make a critical difference in overcoming constraints or in creating confidence, particularly for those new to the business of exporting or of branching out abroad. Examples of various services provided to help exporting SMEs include: in Japan, an Export Financing Loan Guarantee scheme for SMEs to ensure that they have access to export financing services and export insurance; in Canada, the First Time Exporter's Programme designed to help first-time exporters to set up an export business, a Cross-border Export Training Programme and a database service listing companies and products; in Norway, the Export Manager for Hire Programme under which a consultant is provided to a company to help it set up its export business, the Commercial Network Programme, designed to create alliances or networks among SMEs in such areas as export activities, purchasing and R&D, and a programme designed to provide loans to partially meet the cost of establishing SME sales subsidiaries abroad; and in the United Kingdom, the Business Link Network designed to establish a national network of one-stop centres to provide an integrated package of services to SMEs, including exporters. Various other countries, including China, France, Germany and Mauritius, have also established export information and advisory services to SMEs. The organization of trade fairs, often in cooperation with private-sector organizations, provides a highly-valued service to SME exporters, allowing them to come into contact with potential customers and business partners.

24. In the developed countries, various types of institutions have been established, aimed at promoting the internationalization of their SMEs, particularly to developing countries. The types of institutions involved and the different services provided by them are described briefly in an earlier document on the role of SMEs in export development submitted to the first session of the Ad Hoc Working Group (7). Likewise, the activities of the International Trade Centre UNCTAD/GATT in contributing to export development of SMEs are briefly described in that document (8).

25. Where firms succeed in establishing linkages with other firms, whether domestic or foreign, the channels provided by such linkages can often become the most important source of information and assistance to SME exporters. In Japan, a number of large trading companies, which have established their own market intelligence networks abroad, have played an important role in fostering the development of SME exporters.

26. In addition, networking can be established at the level of institutions such as SME support agencies or SME associations. This kind of networking can help to promote the development of inter-firm linkages and thus contribute to the development and modernization of SMEs, including exporting SMEs. An example of networking of institutions is TECHNONET Asia, which groups together 14 participating organizations -- principally SME support agencies -- from 12 countries in Asia and the Pacific. Its programmes are primarily supported by international and bilateral donors and focus on four main areas: dissemmination of industrial information; provision of industrial extension services; facilitation of technology transfer or sharing; and development of indigenous entrepreneurs and enterprises. It may be noted that SEBRAE, a private SME support agency in Brazil, is building up links in the MERCOSUR region, which allow the support agency to provide its various services to SME exporters and importers, as well as to bring them together, within the region.

27. The EMPRETEC programme, a United Nations programme managed by UNCTAD in cooperation with DDSMS in New York, which is designed to detect entrepreneurial talent and foster its development, has evolved to a stage where a process of networking and business links between the African and Latin American regions is emerging. Furthermore, UNCTAD's Global Trade Point Network allows SMEs to benefit from direct access to trade-related information (on products, markets, prices, but also on regulations and statistics for example) and to expand their activities in international markets.

28. The establishment of a network of SME agencies in ASEAN countries is, in fact, an important feature of the ASEAN Programme of Action on SME Development. Such a network will provide a mechanism to exchange information and to pool resources and expertise for SME development in the region. A number of areas for cooperation are envisaged, including policy analysis, including of SME policies and practices in order to draw lessons learned from SME support programmes and to identify "best practices"; finance, such as the possibility of establishing new financing mechanisms, including on a regional basis, for SME development; human resources development, including joint training programmes to upgrade the capabilities of entrepreneurs, managers and technical workers; technology, including sharing of information on technology and experience in the transfer of technology, as well as joint technological development in particular industries; and marketing, including cooperation in marketing and in collective promotion efforts in the form of joint trade exhibitions for particular products. The objective of such cooperation is to contribute to the modernization and rationalization of the SME sector and the strengthening of inter-firm linkages, including between SMEs and large enterprises, as part of the process of industrial deepening and of increasing the manufacturing value added in the region.

29. Likewise, proposals are under consideration for cooperation on SME development in APEC that will address a number of issues, including human resources development (APEC Centre for Technology Exchange and Training for SMEs, networking of SME-related HRD initiatives); access to information (private/business sector networking, EDI and electronic commerce); technology and technology sharing (APEC Technomart, networking among SME promotion organizations related to technology); and finance (APEC Venture Capital Workshop, investment scheme to facilitate the globalization of SMEs in the region) (9).

30. In the light of the above, the areas of policy development where technical cooperation may be strengthened may include (i) promotion of inter-firm linkages and the modernization of SMEs; and (ii) regional cooperation on SME development.

31. As regards the promotion of inter-firm linkages and the modernization of SMEs, donors may help to build up a framework for fostering inter-firm cooperation between their domestic firms and firms in developing and other countries that will encourage the latter to improve their performance so as to be able to compete successfully in international markets, while providing feedback that can help to improve the policy and commercial framework, as well as institutional support, for SME development in the recipient countries (see para. 21 above).

32. Donors can also contribute to regional cooperation on SME development by providing support for the development and networking of SME support agencies, as well as in particular

areas of regional cooperation such as policy analysis and human resources development. In addition, as stated in the above-mentioned report of the Development Assistance Committee, "more innovative mechanisms for promoting regional enterprise development through networks for mutual learning and technological capacity building could be researched and collectively supported by the donor community: such an approach could be an effective way of building regional capabilities to satisfy regional and world markets" (10).

III. Concluding observations

33. In the above discussion, four broad areas for policy development supportive of SMEs have been identified in which technical cooperation may be strengthened. These include (i) the policy and commercial framework for enterprise development, with particular reference to SMEs; (ii) institutional support for SME development; (iii) promotion of inter-firm linkages and the modernization of SMEs; and (iv) regional cooperation on SME development.

34. Such technical cooperation may involve bilateral donors or international organizations. In the case of the latter, it is recognized that there are other organizations of the United Nations system, such as the ILO, UNIDO, the World Bank, UNDP and ITC, which have programmes on SME development and which may wish to brief the Ad Hoc Working Group on their activities. Representatives of ITC and UNIDO have in fact done so at the first session of the Ad Hoc Working Group. Some aspects of UNCTAD's own activities are briefly mentioned (see paragraph 27), and some additional activities may need to be developed in the areas mentioned in paragraph 33 above, in the light of the consideration of these matters by the Ad Hoc Working Group and at UNCTAD IX. In this context, efforts will have to be made to ensure the necessary coordination in meeting the needs of member States.

Notes

1. Employment performance. McKinsey Global Institute. Quoted in: Financial Times, 18 November 1994.

2. See: ECE: "Small and Medium-sized Enterprises in the ECE Region." (TRADE/R.586). Geneva 1992.

3. See Development Assistance Committee: DAC Orientations for Development Cooperation in Support of Private Sector Development. (Paris 1994), p. 13.

4. Ibid., p.16.

5. Ibid., p. 15.

6. Optiz, St., " Export promotion in the context of technical cooperation," in Intereconomics, Vol. 29, No. 3, (Hamburg 1994), p. 139.

7. UNCTAD "The role of small and medium-sized enterprises in export development" (TD/B/WG.7/3), p. 14.

8. Ibid., p. 30.

9. See APEC Small and Medium Enterprise Ministerial Meeting, (Osaka, Japan, 22-23 October 1994), Joint Statement.

10. See Development Assistance Committee, op. cit., p. 28.